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DOL/ILAB FOR TINA MCCARTER
TREASURY FOR LESLIE HULL

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TAGS: ECON EFIN KMCA PGOV CE
SUBJECT: SRI LANKA: 2008 BUDGET WOULD BOOST DEFENSE AND TRANSFERS TO RAJAPAKSA CONSTITUENTS

REF: A. COLOMBO 1562
¶B. COLOMBO 1464

¶1. (SBU) Summary and comment: The Rajapaksa government could survive or fall depending on the outcome of a December 14 final vote on its 2008 budget. The proposed budget continues the president's emphasis on high taxes to fund big government and transfers to his primary constituents: civil servants, farmers, unemployed college graduates, and poor people. The government claims that revenues will keep pace with expenditures, but this is no more likely for the 2008 budget than it was for the 2006 and 2007 budgets, whose deficit spending spurred inflation. The budget significantly raises defense spending and substantially increases allocations to ministries that the president and his brothers control. We share the view of many civil society critics that this budget illustrates the Rajapaksa government's short-sighted, politically driven, and often non-transparent management of the Sri Lankan economy. From what this budget indicates, we doubt the government can contain inflation or realize the 7.5 percent growth it predicts for 2008. End summary and comment.

THIRD "MAHINDA CHINTANA" BUDGET PROMOTES BIG GOVERNMENT
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¶2. (SBU) President Mahinda Rajapaksa presented to Parliament on November 7 his government's proposed budget for 2008. Sri Lanka's fiscal year follows the calendar year; its budget process involves a series of three "readings" of the budget in parliament between October through December. The budget narrowly passed on the November 19 second reading (ref A); the final reading is scheduled for December 14. Defeat of the budget could result in the collapse of Rajapaksa' Sri Lanka Freedom Party-led coalition, so the vote will be purely a political contest, not a reflection of views on the budget.

¶3. (SBU) Rajapaksa told Parliament that he had emphasized four priorities in formulating the 2008 budget: national security, infrastructure development, relief to low income groups, and "reawakening" local entrepreneurs and industry. National security -- in the form of stepped up military efforts to eliminate or contain the LTTE -- has been the dominant theme of the Rajapaksa government. The other three priorities are central to the Rajapaksa's "Mahinda Chintana" populist emphasis on big government and transfers to favored constituencies. The government rightly believes that channeling investment into infrastructure will unlock

growth potential. Its poverty relief programs are both well-intentioned and politically motivated. Many of its "reawakening" efforts involve subsidies and protection that are unlikely to stimulate productive enterprises, but again, are politically popular.

THE BIG PICTURE: SEEKING TO CONTAIN DEFICIT

¶4. (SBU) The 2008 budget forecasts large increases in both expenditure and revenue, but expenditure continues to far exceed revenue (see Fiscal Data table below). In comparison with the 2007 budget, total government spending will rise 21 percent to 1,044 billion rupees (Rs), and revenue will rise 24 percent to Rs 751 billion, resulting in a deficit of Rs 293 billion. The government cites this projected deficit as equal to 7.0 percent of GDP, which would be an improvement compared with recent deficits of 8-9 percent of GDP, but this relies on the government's optimistic estimate of 7.5 percent GDP growth in 2008. Using the IMF's projected 2008 GDP growth of 6 percent, the projected deficit would amount to 7.7 percent of GDP.

¶5. (SBU) More than two-thirds of the budget goes to recurrent expenditure -- interest payments, salaries, pensions, subsidies, and welfare payments. The remaining third would be for Rs 335 billion in capital investment, but inevitable revenue shortfalls will likely cause this amount to decrease. (Note: About nine months into each budget year, when the government finds that it has not generated as much revenue as it projected, the Finance Ministry instructs

ministries to defer all remaining capital spending, in order to contain the deficit. For example, late in 2007, the government said actual capital spending would be 23 percent below the budgeted amount. The only exception to this restraint on capital spending was in the Ministry of Defense, whose capital spending actually increased by 11 percent.)

¶6. (U) FISCAL DATA, 2007-2008: Comparison between the proposed 2007 budget, the revised 2007 budget released in September 2007, and the proposed 2008 budget. Figures in parentheses represent the percentage of GDP. Sources: Central Bank and the 2008 Budget speech.

Year	2007 revised	2007	2008
Billions of rupees			
Total Expenditure	898 (28)	862 (24)	1044 (24)
-current	596	630	713
-capital	303	233	335
-other	-	-2	-4
Total Revenue	600 (19)	605 (17)	751 (18)
Budget Deficit	297 (9.2)	257 (7.2)	293 (7.0)

DEFENSE: INCREASES TO "SUPPORT INVESTMENT CLIMATE"

¶7. (SBU) Finance Secretary P.B. Jayasundera told Colombo business people in November that high expenditure on national security is essential to create a stable investment climate, and therefore that the government "need not be shy about defense spending" as it had been in the past. For this reason, he said, the government had not tried to hide defense spending within the budget as previous governments had.

¶8. (SBU) Defense, budgeted at Rs 166 billion ($1.4 billion), is the second largest expenditure area after interest payments. It would account for nearly 16 percent of total 2008 spending -- equivalent to about 4 percent of GDP (or 4.3 percent with more realistic GDP growth figures). The planned increase in 2008 represents a jump of 19 percent over the 2007 budgeted figure. Actual 2007 defense expenditure swelled 49 percent to Rs 156 billion from Rs 105 billion in 2006 -- an increase in real terms of about 32 percent given

inflation averaging about 17 percent. The 2008 figure is also likely to come in higher than budgeted, though possibly not as drastically as the 2007 amount grew. At the proposed 2008 level, the Rajapaksa government will have increased spending on defense from about $50 per capita to about $74 between 2006 and 2008.

	2006	2007	2007	2008
	est.	rev.	est.	
Defense (Rs billion)	104.8	139.6	155.7	166.4
($ billion)	1.0	1.3	1.4	1.4
As percent				
of GDP	3.6%	4.3%	4.4%	4.0%
of govt expenditure	14.7%	15.5%	18.2%	15.9%

Source: Budget estimates 2008

EDUCATION AND HEALTH: UNIVERSAL BUT MEDIOCRE

¶9. (SBU) Sri Lanka continues to provide free universal education and health care. In the budget address, the President said that in allocating funds for education, the government aimed to improve

teacher training and to upgrade university facilities to increase annual student intake to 20,000 from 16,635 now. He reported that the government would increase funding for free text books, scholarships, school uniforms, midday meals, and school bus services. The President likewise promised to increase health sector funding to improve hospitals, procure medicines, and provide living quarters for doctors.

¶10. (SBU) The Rajapaksa government has increased per capita spending on education and health from $66 to $78 between 2006 and 2008. (By comparison, it has taken defense spending from about $50 to about $70 per capita during the same period.) Even at these levels, the systems are providing broad, but mediocre services. For example, in education, only 49 percent of tenth grade students pass their final "O-level" exam. And only 14 percent of twelfth grade students who pass the "A-level" exam can actually enter university, due to insufficient capacity in the public system. To avoid such outcomes, a recent Asian Development Bank report found, many families are spending more on private tuition. Similarly, to avoid delays and poor care, many Sri Lankans turn to private health providers if they can afford to do so.

INFRASTRUCTURE AND EASTERN PROVINCE INVESTMENT INCENTIVES

¶11. (SBU) The Rajapaksa government seeks to boost investment in infrastructure in order to "unlock" economic development potential, especially in the less developed parts of the country outside of the capital. It has focused on particular on projects in the president's home district of Hambantota, where it seeks to create a bulk goods port, a small international airport, and a rail/road link to the capital. The government also envisions continued investment in irrigation systems that would expand cultivable land in dry parts of the country -- mostly in the south, which is also the heart of Rajapaksa's voter base. The government has sought to direct aid from bilateral and multilateral donors into these projects, and says that it will finance whatever donors will not. In the budget speech, the president highlighted the Hambantota and irrigation projects. However, as noted above, lower than predicted revenues are likely to force the government to curtail it planned capital spending, so these projects are likely to remain dependent on donor or investor interest.

¶12. (SBU) The President also stated that the government would dedicate capital funds to develop the Eastern Province, over which it regained control from the ethnic separatist Liberation Tigers of Tamil Eelam in mid-2007. Of the Rs 335 billion the government budgeted for capital investment, 8 billion are specifically designated for the east. The budget also offered incentives for private development in the Eastern Province, including a five-year tax holiday for any investment over Rs 50 million which generates 50 or more jobs.

MORE SPENDING ON FAVORED CONSTITUENTS...

¶13. (SBU) The 2008 budget includes heavy government spending to provide relief to low income groups, continue to expand the civil service as a source of employment, and support farmers and fishermen. The budget also promises a range of subsidies, incentives, and protections to support certain domestic industry sectors.

¶14. (SBU) The poor would receive significant new support in the 2008 budget. The 1.8 million recipients of the government's "Samurdhi" welfare program will get an additional kerosene subsidy of Rs 100 per month in 2008 as part of a 10 percent increase in the overall Samurdhi budget in 2008. The government also said it would continue welfare programs that would provide nutritional food to expectant mothers and free breakfasts to low income school children. Finally, the government plans various programs to deliver essential foodstuffs to poor people: revival of a previously failed network of government-run "wholesale" food outlets; expansion of existing

wholesale food cooperatives; and creation of a state-owned trading company to import and distribute food to these wholesale and cooperative stores.

¶15. (SBU) Public servants will consume 34 percent of expected 2008 tax revenue. (Including government pensioners, expenditure on public servants equals about 45 percent of revenue.) Sri Lanka's civil service now numbers about 1.2 million after the Rajapaksa government recruited about 100,000 new employees in 2006-2007. The President announced the government will hire a further 15,000 university graduates into the public service in 2008. Public servants, who received substantial salary increases in 2006-2007, will receive a cost of living increase averaging about four percent in their 2008 salaries. They will continue to enjoy such costly benefits as the right to import cars at a 35 percent tax rate (compared to the standard 200-300 percent) and subsidies on their housing-related interest payments.

¶16. (SBU) The budget contains a range of proposals to help farmers and fishermen. These include increases in taxes on imported agricultural products in order to enable less efficient local farmers to compete; expanded subsidies on fertilizer, seeds, and other inputs; a partial debt write-off for rice millers; subsidized loans to farmers and millers; and a guaranteed price scheme for fish. The government also plans a series of incentives to increase dairy production, including guaranteed minimum prices for milk producers; subsidized loans to develop 50,000 small livestock farms; and VAT exemption and Rs 100 million for cold storage facilities. (Comment: We regard the dairy incentives as well-conceived and likely to be productive, because the sector is underdeveloped; the rice incentives, by contrast, are pure handouts to an overcrowded, traditionally influential, but perennially inefficient sector.)

¶17. (SBU) The budget also contains programs to help develop various industrial sectors. It proposes tax exemptions to encourage import of cargo ships and their registration under the Sri Lanka flag. The gem and jewelry sector would get tax breaks to encourage domestic cutting and polishing and subsidized credit to attract new investment. Domestic textile production is to be encouraged through taxes on import of textiles for domestic garment production. (Textile imports for export production would remain tax free.)

...AT THE COST OF FURTHER TAX INCREASES

¶18. (SBU) The budget proposes higher taxes, both in the form of expanded collection and higher rates, to enable the government to provide the benefits described above and to continue similar existing programs. The budget forecasts a 25 percent (Rs 136 billion) increase in tax collections, of which Rs 24 billion would come from new tax measures imposed especially on companies and imports.

¶19. (SBU) Sri Lanka's direct taxation involves personal income and corporate taxes. The budget would keep personal income tax rates unchanged at 5-35 percent. For corporations, all but the smallest

have a 35 percent income tax rate and a 10 percent dividend tax. The budget would not change these rates, but it would increase the rate of a "Social Responsibility Levy" (first imposed in 2005 to fund child welfare programs) on profits from 1 percent to 1.5 percent. The budget proposed to remove this levy from personal income taxes.

¶20. (SBU) The budget would hit harder on indirect taxes -- many imposed on imports on top of standard tariffs -- that generate much of Sri Lanka's tax revenue. The 2008 budget, like its predecessors, would increase the rates of the following taxes:

--Import duty surcharge (on all imports except certain "essential" items)

--Export Development Board levy (on thousands of "non-essential imports")

--Excise Duty (on imported and local alcohol, cigarettes, motor vehicles, and other selected items)

--Regional Infrastructure Levy (on motor vehicles)

¶21. (SBU) The budget does not change the Value Added Tax (VAT) rate or that of the Ports and Airports Levy. Aside from VAT, each of these taxes was originally created ostensibly to dedicate funds for provision of specific government services. However, the government evidently uses the majority of the funds as general revenue. For example, although there is no sign that the Regional Infrastructure Levy has been used as intended to improve roads, the total tax on cars with 1500 cc or smaller engines will rise from 173 percent to 197 percent.

ENVIRONMENT CONSERVATION LEVY

¶22. (SBU) The budget introduced a new "Environment Conservation Levy" to counter damage caused to the environment through water and air pollution and soil erosion. The government estimates the cost of these forms of environmental damage to be over 2 percent of GDP. The government intends to devote more funds to environmental protection by taxing individuals, businesses, and items considered to be harmful to the environment. It will collect Rs 20 per month from every household that owns a vehicle, a telephone and an electricity connection. (Comment: While the environment conservation goal is laudable, this is likely to be another of the many supposedly purpose-designated taxes that in practice mostly ends up going towards general revenue.)

RAJAPKSE FAMILY CONTROLS 53% OF THE BUDGET

¶23. (SBU) Another notable feature of the 2008 budget is its heavy total allocations to ministries controlled by President Rajapaksa or his brothers. Between them, the four brothers effectively control 53 percent of the 2008 government budget. (Note: Some sources, such as a recent "Economist" article about the Rajapaksa family, cite a figure of 70 percent for their control of the budget, but this appears exaggerated.) The President directly controls 51 percent of the budget: Ministry of Finance and Planning (29 percent), Ministry of Defense (16 percent, run by brother Gothabaya as Secretary), Ministry of Nation Building (5 percent for politically important poverty alleviation and village development programs, run by brother Basil as Advisor) and Office of the President (0.6 percent). The President's elder brother, Chamal, heads the Ministry of Ports and Aviation (2 percent) and the Ministry of Irrigation and Water Management (0.06 percent). One commentator on the budget noted that these ministries were the only ones whose budget allocations increased by more than the rate of inflation.

¶24. (SBU) The President has used his control of the Ministry of Finance budget in a way that critics have charged is non-transparent and non-accountable. Beginning in 2003 the government has allocated increasingly large sums to a Finance Ministry account called the "Development Activities Program." The government has used this account to pay for expenses in various ministries as they arise throughout the year, by transferring funds on a case-by-case basis.

This has given the president discretion over un-budgeted expenditures proposed by his 108 ministers, deputy ministers and non-cabinet ministers, as well as by his own office.

¶25. (SBU) In a required "Fiscal Management Report," the government stated that its January through October 2007 expenditures in this account totaled 36 billion rupees. Of this, however, the government only gave details on 11 billion in expenses -- for uses like "personal emoluments," "foreign travel," "purchase of vehicles," and "contractual services," plus capitalization of a new bank, and "expenses connected with failed state enterprises." The 2008 budget allocates 50 billion rupees -- 5 percent of the total budget -- to this Finance Ministry account.

¶26. (SBU) Several parties challenged this practice in the Supreme Court, saying it unconstitutionally circumvents parliamentary control over public finance. The Court quickly instructed the government to more fully report the use of these funds to Parliament as required by the Fiscal Management Responsibility Act; it did not, however, accept the claim that the government's actions were unconstitutional. Nevertheless, the Chairman of the Committee on Public Enterprises (COPE, ref B) resigned from the government to protest the government's non-transparent use of these funds, failure to hold accountable ministers accused of corruption, and under-funding of poverty programs relative to the generous compensation provided to ministers.

BUSINESS AND CIVIL SOCIETY NOT IMPRESSED

¶27. (SBU) The following is a selection of comments reported in press coverage of a variety of public programs convened in Colombo to discuss the budget:

-- A Nestle rep urged the government to reduce waste and inefficiency in the state sector, in order to be more responsible towards the people whose welfare it is supposed to manage.

-- The Business for Peace Alliance lauded the government's plans to improve regional and provincial infrastructure. But it said the "colossal" increase in defense spending overshadows the proposed spending on productive sectors of the economy and "casts clouds on the hope for peace." It added, "with the rate of inflation already at an unbearable level, such increased expenditure on non-constructive sectors will have a negative impact on the economy."

-- Representatives of chambers of commerce representing small and medium enterprises were generally positive about the budget's support for local industry. However, they criticized proposals for increased spending on government.

-- The Sunday Times quoted an unnamed "top businessman" saying that "the budget is an eyewash, the country is on a major economic decline and the economy is mismanaged..." and another describing the budget as "disgraceful -- there is nothing conducive for the business sector and there are a lot of stealth taxes that are imposed on them."

-- A professor of economics from the University of Colombo told the Sunday Times that incentives for investment in the Eastern Province would not work if the lack of human and physical capital in the region was not addressed first.

-- Another leading economist criticized the government's public expenditure as "welfare oriented rather than workfare oriented" and tax policy as regressive due to its dependence on indirect taxes. He advocated decentralized tax collection and spending, so that development efforts would be more responsive to actual needs rather than central government political priorities. He credited the government's Eastern Province development plans in principle but said they were unlikely to succeed without a return to democratic rule in the province.

COMMENT: THE CRITICS ARE RIGHT

¶28. (SBU) It would not be realistic to expect the Rajapaksa government -- which was elected on an economic platform that emphasized big government programs and transfers -- to propose a budget with the kind of reforms and priorities we think are necessary for Sri Lanka to realize its great economic potential. This budget will not change the fact that much of Sri Lanka's growth comes in spite of the government, not because of the programs it says will stimulate growth. The government's attempt to contain its fiscal deficits is commendable, but comes from fear of inflation of

a political liability, not belief in sound fiscal management. For this reason, the government continues to avoid the hard budgetary compromises needed to reduce inflation. Thus Sri Lanka in 2008 is likely to continue to experience high inflation and high interest rates, and as a result is unlikely to see the 7.5 percent GDP growth that the government predicts.
BLAKE